

Local Members Interest	
Nil	

PENSIONS COMMITTEE – 20 OCTOBER 2017

Report of the Director of Finance and Resources

Implementation of the Markets in Financial Instruments Directive (MiFID II)

Recommendation of the Chairman

1. That the Pensions Committee:
 - (i) note the requirements of MiFID II and the potential impact on the Staffordshire Pension Fund of losing professional client status from 3 January 2018;
 - (ii) note that in electing for professional client status, the Staffordshire Pension Fund will automatically forego the protections afforded to retail clients as set out in Appendix 2; and
 - (iii) authorise the Director of Finance and Resources to apply for elective professional client status for the Staffordshire Pension Fund, with all relevant investment and financial institutions and determine the most appropriate basis of the application, either via full or single service.

Introduction

2. This paper outlines the impact of the implementation of the European Markets in Financial Instruments Directive 2014/65 (MiFID II), and in particular, the risk to Staffordshire County Council as the administering authority for the Staffordshire Pension Fund of becoming a retail client on 3 January 2018. It recommends that the Committee approve that elections for professional client status are made on behalf of the Staffordshire Pension Fund, as soon possible.

Background

3. Under the current UK regulatory framework, local authorities are automatically categorised as 'per-se professional' clients in respect of non-MiFID scope business and are categorised as 'per-se professional' clients for MiFID scope business if they satisfy the MiFID Large Undertakings test. Local authorities that do not satisfy the Large Undertakings test may 'opt up' to elective professional client status if they fulfil certain 'opt-up criteria'.
4. Following the introduction of MiFID II from 3 January 2018, local authorities will lose the automatic right to be categorised as per-se professional clients by banks, investment managers, brokers and advisors. Instead, all local authorities must be

classified as 'retail clients' by these firms, unless they are 'opted up' by the firms to 'elective professional client' status. The criteria for 'opting up' in the UK are specified by the Financial Conduct Authority (FCA). They require an assessment of quantitative factors (relating to the nature and scale of the client's business); and qualitative factors (relating to the expertise, experience and knowledge of key decision makers).

5. The assessment aims to demonstrate whether the client is capable of making its own investment decisions and understanding the risks involved. It is for the service provider to determine whether or not, based on the information submitted by clients, the appropriate 'opting up' criteria are met.

Potential Impact

6. A move to retail client status would mean that all financial services firms like banks, investment managers, brokers and advisors would have to treat local authorities in the same way they do non-professional individuals and small businesses. This entails providing a raft of protections to ensure the suitability of investment products and the evidence that all risks and product features have been fully explained. Whilst this provides a higher standard of protection for the client, it also involves more work and potentially cost, for both the firm and the client (investor), for the purpose of satisfying the regulator that all such requirements have been met.
7. These protections would ultimately mean that the Fund would be prevented from accessing a wide range of products and financial instruments, which are deemed unsuitable for retail investors, and yet essential for the Fund to implement and deliver an effective and diversified investment strategy. The Fund would also have fewer options in terms of which financial institutions or investment managers it could appoint, as many institutions currently serving local authorities, are not licensed for retail business, and may not wish to incur the costs involved in seeking additional regulatory permissions.
8. Even if an institution did secure the ability to deal with retail clients, the range of instruments it could make available to the client will be limited to those defined under FCA rules as 'non-complex' which would exclude many of the asset classes currently included in LGPS fund's portfolios. In many cases managers will no longer be able to even discuss ('promote') certain asset classes and vehicles with the local authority as a retail client.
9. In electing for professional client status, the Fund would effectively, forego the protections afforded to retail clients (the details of which are set out in Appendix 2). The Committee should note that these protections are **not** currently enjoyed by the Fund anyway albeit the associated risks are mitigated through a range of different controls, including:
 - access to independent actuarial and investment advice;
 - the LGPS investment regulations;
 - the Fund's own governance and policy framework;

- the County Council's Constitution and Scheme of Delegation;
- access and membership of professional networks; and
- an experienced and well qualified officer team

Opting Up to Professional Client Status

10. MiFID II allows for retail clients which meet certain conditions to elect to be treated as professional clients i.e. to 'opt up'. There are two tests which must be met by a client when being assessed by a financial institution; the quantitative test and the qualitative test.
11. The Local Government Pension Scheme Advisory Board (SAB) and the Local Government Association (LGA), along with the Department for Communities and Local Government (DCLG) and the Investment Association (IA), have successfully lobbied the FCA to make the opt up 'test' better suited to the unique situation of local authorities.
12. The latest guidance recognises the status of LGPS administering authorities as providing a 'pass' for the quantitative test while the qualitative test can now be performed on the administering authority as a collective, rather than on an individual basis.
13. The election to professional status must be completed with all financial institutions prior to the change of status on 3 January 2018. Failure to do so by local authorities would result in the financial institution having to take 'appropriate action' in accordance with their own internal compliance procedures, which could include terminating their relationship with the Fund.
14. SAB and the LGA have worked with the investment industry representative bodies, including the Investment Association (IA) and the British Venture Capital Association (BVCA) to develop a standard opt up process, including supporting information templates and pro-forma correspondence. This should enable a consistent approach to assessment and avoid authorities having to submit different information, in different formats to the various different financial institutions they use. A summary of the process is set out in a flow chart in Appendix 3.
15. Applications for professional client status can be made in respect of either all services offered by an institution (irrespective of whether they are currently used), or a particular service only. Given that all future procurement will be undertaken by LGPS Central Ltd on the Fund's behalf, wherever possible, it makes sense to limit applications to cover only those services currently used, particularly if this is likely to speed up the assessment process. It is recommended that the Director of Finance and Resources determines the most appropriate basis of the application; either via full or single service.
16. Authorities will not be required to renew their elections on a regular basis but they will be required to review the information provided as part of the opt up process and

notify institutions of any material changes in circumstance which could affect their status. For example, if there was a loss of expertise due to turnover, or the relationship with the Fund's investment advisor was terminated.

LGPS Central Ltd

17. LGPS Central Ltd will be professional investors in their own right so will not need to opt up with the financial institutions they appoint. Staffordshire Pension Fund will however, need to opt up with LGPS Central in order to access the full range of services and sub-funds on offer.
18. Elections to professional status will still be required for every financial institution the Fund uses outside the pool. This will include investment managers who are retained to manage legacy assets pending their transition into the pool.

Next Steps

19. So that there is no risk of professional client status not being maintained and due to the 3 January 2018 deadline and the timing of this Committee, the Director of Finance and Resources has already begun to submit applications to all the Fund's current investment and financial service providers. This has been with the caveat that this is subject to the approval of this Committee at its meeting today. This action has been taken to avoid any potential disruption to the delivery of the Fund's Investment Strategy and ensure compliance with the new regulatory provisions which take effect from 3 January 2018.

Andrew Burns
Director of Finance and Resources

Contact : Melanie Stokes
Telephone No. (01785) 276330

Background Documents:
Markets in Financial Instruments Directive 2014/65
FCA Handbook COBS 3.5 Professional Clients

1. **Equalities implications:** There are no direct equalities implications arising from this report.
2. **Legal implications:** These have been addressed in the report.
3. **Resource and Value for money implications:** There are no direct resource or value for money implications arising from this report. However, the failure to opt up to elective professional status could result in significant financial risk to the Staffordshire Pension Fund.
4. **Risk implications:** The failure to opt up to elective professional status could result in significant financial risk to the Staffordshire Pension Fund.
5. **Climate Change implications:** There are no direct climate change implications arising from this report.

WARNINGS - LOSS OF PROTECTIONS AS A PROFESSIONAL CLIENT

Professional Clients are entitled to fewer protections under the UK and EU regulatory regimes than is otherwise the case for Retail Clients. This document contains, for information purposes only, a summary of the protections that you will lose if you request and agree to be treated as a Professional Client.

1. Communicating with clients, including financial promotions

As a Professional Client the simplicity and frequency in which the firm communicates with you may be different to the way in which they would communicate with a Retail Client. They will ensure however that our communication remains fair, clear and not misleading.

2. Information about the firm, its services and remuneration

The type of information that the firm provides to Retail Clients about itself, its services and its products and how it is remunerated differs to what the firm provides to Professional Clients. In particular,

- (A) The firm is obliged to provide information on these areas to all clients but the granularity, medium and timing of such provision may be less specific for clients that are not Retail Clients; and
- (B) there are particular restrictions on the remuneration structure for staff providing services to Retail Clients which may not be applicable in respect of staff providing services to Professional Clients;
- (C) the information which the firm provides in relation to costs and charges for its services and/or products may not be as comprehensive for Professional Clients as it would be for Retail Clients, for example, they are required when offering packaged products and services to provide additional information to Retail Clients on the risks and components making up that package; and
- (D) when handling orders on behalf of Retail Clients, the firm has an obligation to inform them about any material difficulties in carrying out the orders; this obligation may not apply in respect of Professional Clients.

3. Suitability

In the course of providing advice or in the course of providing discretionary management services, when assessing suitability for Professional Clients, the firm is entitled to assume that in relation to the products, transactions and services for which you have been so classified, that you have the necessary level of experience and knowledge to understand the risks involved in the management of your investments. The firm will assess this information separately for Retail Clients and would be required to provide Retail Clients with a suitability report.

4. **Appropriateness**

For transactions where the firm does not provide you with investment advice or discretionary management services (such as an execution-only trade), it may be required to assess whether the transaction is appropriate. In respect of a Retail Client, there is a specified test for ascertaining whether the client has the requisite investment knowledge and experience to understand the risks associated with the relevant transaction. However, in respect of a Professional Client, the firm is entitled to assume that they have the necessary level of experience, knowledge and expertise to understand the risks involved in a transaction in products and services for which they are classified as a Professional Client.

5. **Dealing**

A range of factors may be considered for Professional Clients in order to achieve best execution (price is an important factor but the relative importance of other different factors, such as speed, costs and fees may vary). In contrast, when undertaking transactions for Retail Clients, the total consideration, representing the price of the financial instrument and the costs relating to execution, must be the overriding factor in any execution.

6. **Reporting information to clients**

For transactions where the firm does not provide discretionary management services (such as an execution-only transactions), the timeframe for our providing confirmation that an order has been carried out is more rigorous for Retail Clients' orders than Professional Clients' orders.

7. **Client reporting**

Investment firms that hold a retail client account that includes positions in leveraged financial instruments or contingent liability transactions shall inform the Retail Client, where the initial value of each instrument depreciates by 10% and thereafter at multiples of 10%. These reports do not have to be produced for Professional Clients.

8. **Financial Ombudsman Service**

The services of the Financial Ombudsman Service may not be available to you as a Professional Client.

9. **Investor compensation**

Eligibility for compensation from the Financial Services Compensation Scheme is not contingent on your categorisation but on how your organisation is constituted. Hence, depending on how you are constituted you may not have access to the Financial Services Compensation Scheme.

10. **Exclusion of liability**

The FCA rules restrict the firm's ability to exclude or restrict any duty of liability which the firm owes to Retail Clients more strictly than in respect of Professional Clients.

11. **Trading obligation**

In respect of shares admitted to trading on a regulated market or traded on a trading venue, the firm may, in relation to the investments of Retail Clients, only arrange for such trades to be carried out on a regulated market, a multilateral trading facility, a systematic internaliser or a third-country trading venue. This is a restriction which may not apply in respect of trading carried out for Professional Clients.

12. **Transfer of financial collateral arrangements**

As a Professional Client, the firm may conclude title transfer financial collateral arrangements with you for the purpose of securing or covering your present or future, actual or contingent or prospective obligations, which would not be possible for Retail Clients.

13. **Client money**

The requirements under the client money rules in the FCA Handbook (CASS) are more prescriptive and provide more protection in respect of Retail Clients than in respect of Professional Clients.

It should be noted that at all times you will have the right to request a different client categorisation and that you will be responsible for keeping the firm informed of any change that could affect your categorisation as a Professional Client.

UK Local Authority Client Opt-Up Process

